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Unreasonably Low Salaries in S Corporations: A Prescription for Additional Payroll Taxes, Interest and Penalties

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Unreasonably Low Salaries in S Corporations: A Prescription For Additional Payroll Taxes, Interest and Penalties

-by Neil E. Harl*

It has been clear for more than two decades – unreasonably low salaries and wages in an S corporation will, almost certainly, lead to audits, additional FICA and FUTA tax assessments, interest and penalties.¹ Despite the overwhelming authority favoring so-called “deemed” wages,² and clear warnings against the practice,³ the cases continue to be litigated. A TIGTA Report estimates that shareholders underreported \$23.6 billion of compensation in 2003 and 2004.

Guidance on “reasonable compensation”

Unfortunately, the Internal Revenue Service has published no guidance specifically on the amount of distributions to shareholders of S corporations that should be included as wages or salary and, more importantly, has not provided a procedure for determining what is reasonable compensation. The relevant regulation⁴ states –

“The term “wages” means all remuneration for employment unless specifically excepted under section 3121(a).”

IRS has issued two revenue rulings bearing on the issue, however. In the facts of *Rev. Rul. 74-44*,⁵ shareholders performed services for an S corporation and elected, with approval of the corporation, to receive dividends from the corporation rather than wages. The Internal Revenue Service concluded that the dividends were actually reasonable compensation for the services rendered and were subject to payroll taxes. In *Rev. Rul. 73-361*,⁶ an officer (who was also a shareholder) performed substantial services as an officer and received a salary. The ruling found that the individual was an employee of the corporation for purposes of FICA, FUTA and income tax withholding. The ruling noted that a corporate officer who did not perform more than minor services (and who received no remuneration and was entitled to no remuneration) was not an employee.

However, more than a dozen cases have been litigated⁷ with eleven appealed to courts of appeal⁸ and three appealed to the United States Supreme Court.⁹ All upheld the IRS position.

The case of *Watson v. United States*

The taxpayer in *Watson v. United States*¹⁰ had been in practice as a Certified Public Accountant for more than 25 years when the IRS audited the firm and assessed additional payroll taxes, penalties and interest. The taxpayer had received a salary of \$12,000 in 1998

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and, in the years under audit, 2002 and 2003, had received a salary of \$24,000 per year.¹¹ Gross billings to clients from the practice in 2003 totaled \$200,380.36 and the taxpayer received a profit distribution from the S corporation of \$175,470 that same year.¹²

The United States District Court held that a substantial part of the payments was compensation for services performed by the shareholder/employee rather than a distribution of earnings and profits which would not be subject to payroll taxes. Accordingly, the taxpayer's claims for refunds of taxes paid after audit were denied and assessments of additional unpaid payroll taxes, interest and penalties were upheld. The court accepted the report of an expert witness for IRS as to what would be a reasonable salary for the taxpayer.¹³ That figure was \$91,044 per year. The expert witness testified that the salary actually paid was below the median starting salary for new accounting graduates from the University of Iowa in 2002 (\$40,000) and for 2003 accounting graduates (just under \$40,000) and below the minimum reported offer for an accounting graduate in 2002 (\$26,000).¹⁴

As for the authority of the Internal Revenue Service to recharacterize S corporation distributions as salary or wages, the trial court found the 1990 case of *Radtke v. United States*¹⁵ to be "particularly persuasive."¹⁶ In *Radtke v. United States*,¹⁷ a Wisconsin attorney had created an S corporation to conduct a law practice, took no salary and received dividend payments. As the District Court stated, "... courts reviewing tax questions are obligated to look at the substance, not the form, of the transactions at issue."¹⁸ The appellate court's response to the argument by the taxpayers was "these payments were clearly remuneration for services performed by Radtke and therefore fall within the statutory and regulatory definition of wages."¹⁹

ENDNOTES

¹ See, e.g., *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990) (dividends in lieu of salary constituted wages subject to payroll taxes); *Radtke v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990) (dividends paid instead of salary constituted wages subject to federal employment taxes). See generally 7 Harl, *Agricultural Law* § 56.02 (2011); Harl, *Agricultural Law Manual* § 7.02[3][c] (2011); 2 Harl, *Farm Income Tax Manual* § 7.04[1][b][iii] (2011 ed.).

² See *Watson v. United States*, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,443 (S.D. Iowa 2010) (salary from S corporation to CPA was unreasonably low; deemed wages subject to employment taxes).

³ E.g., GAO Report 10-195, January 14, 2010 ("failure to pay adequate compensation" one example of "extensive noncompliance by S corporations"); Treasury Inspector General for Tax Administration, "Actions Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations," Ref. No. 2005-30-080 (May 2005).

⁴ Treas. Reg. § 31.3121(a)-1(b).

⁵ 1974-1 C.B. 287.

⁶ 1973-2 C.B. 331.

⁷ See 2 Harl, *Farm Income Tax Manual* § 7.04[1][b][iii],

footnote 289 (2011 ed.).

⁸ *Id.*

⁹ *Id.*

¹⁰ 2011-1 U.S. Tax Cas. (CCH) ¶ 50,443 (S.D. Iowa 2010).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990) (dividends paid instead of salary constituted wages subject to federal employment taxes).

¹⁶ *Watson v. United States*, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,443 (S.D. Iowa 2010).

¹⁷ 895 F.2d 1196 (7th Cir. 1990), *aff'g*, 712 F. Supp. 143 (E.D. Wis. 1989).

¹⁸ 712 F. Supp. 143 (E.D. Wis. 1989).

¹⁹ 895 F.2d 1196 (7th Cir. 1990).

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